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17
18 **UNITED STATES BANKRUPTCY COURT**
FOR THE DISTRICT OF NEVADA

19 In re:

20 SOUTH EDGE, LLC,

21 Involuntary Debtor.

Case No.: 10-32968

Chapter 11

**Notice of Motion and Motion to Appoint an
Interim and Permanent Chapter 11
Trustee for South Edge, LLC During (i)
the "Gap" Period and (ii) On A Permanent
Basis; Memorandum of Points and
Authorities**

Hearing Information

Date: TBD

Time: TBD

Courtroom: ☐

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1 JPMorgan Chase Bank, N.A., as a petitioning creditor, Agent and Lender under the Credit
2 Agreement ("JPMorgan" or "Movant"), submits this Motion to Appoint an Interim and
3 Permanent Chapter 11 Trustee for South Edge, LLC, a Nevada limited liability company ("South
4 Edge" or "Debtor") during (i) the "Gap" Period and (ii) on a Permanent Basis (the "Motion"),
5 together with the supporting declarations (collectively the "Declarations") of John P. McDonagh
6 (the "McDonagh Decl."), Michael D. Ross (the "Ross Decl."), and James E. Hough (the "Hough
7 Decl.").

8
9 **I.
PRELIMINARY STATEMENT**

10 On December 9, 2010, JPMorgan (in its capacity as a Lender to South Edge), together
11 with Credit Agricole Corporate and Investment Bank ("Credit Agricole") and Wells Fargo Bank,
12 N.A. ("Wells Fargo") (also Lenders to South Edge) filed an involuntary Chapter 11 petition
13 against South Edge under section 303 of title 11 of the United States Code (the "Bankruptcy
14 Code") in the U.S. Bankruptcy Court, District of Nevada (the "Court").

15 This involuntary Chapter 11 case, in combination with the appointment of a Chapter 11
16 trustee, is the last hope of rescuing South Edge and its "Inspirada" project (the "Project") from the
17 waste and precipitous decline that has been caused, and will continue to be caused, by Debtor's
18 controlling insiders. These insiders are sacrificing the Project and repudiating Debtor's
19 obligations in a quest for greater profits at the expense of not only approximately 39 lenders to
20 whom the insiders seek to shift their losses, but also the City of Henderson, Debtor's other
21 creditors and other parties in interest. The Project can endure neither the insiders' persistent
22 neglect, self-dealing and abuse nor the drawn out litigation favored by the insiders and their
23 affiliates.

24 The appointment of a trustee under section 1104(a) of the Bankruptcy Code is mandatory
25 where, as here, there is overwhelming "cause" for the appointment of a trustee under section
26 1104(a)(1) of the Bankruptcy Code. In addition, appointment of a trustee under section
27 1104(a)(2) is appropriate because having an independent fiduciary replace the incompetent, self-
28

1 dealing insiders that currently control South Edge is clearly in the best interests of South Edge's
2 creditors and the community at large.

3 Movant seeks the appointment of both (i) an interim trustee to serve pending the entry of
4 an order for relief, and (ii) a permanent Chapter 11 trustee to be appointed immediately upon the
5 entry of an order for relief. Such relief is warranted under section 1104(a) of the Bankruptcy
6 Code because:

- 7 • In the spring of 2008, the Debtor's controlling insiders intentionally shut down the
8 Project by refusing to seek further capital contributions from themselves and South
9 Edge's other members;
- 10 • The Debtor's management committee has squandered opportunities to enhance the
11 value of the Project and obtain significant monetary recoveries for South Edge,
12 including realizing millions of dollars of municipal financing. Unless promptly
13 remedied, the intentional failure to capitalize on this opportunity, places those
14 funds in jeopardy;
- 15 • The Debtor's controlling insiders have failed to arrange for essential health, safety
16 and maintenance work at the Project and their continued neglect will most
17 certainly result in the loss or impairment of essential City permits and entitlements.
- 18 • The Debtor's controlling insiders have breached their fiduciary and contractual
19 obligations to South Edge, while at the same time using their considerable
20 financial resources to wage a litigation campaign against the Lenders in
21 furtherance of their own objectives at the expense of South Edge and its estate;
- 22 • The Debtor's controlling insiders have breached their contractual obligations to the
23 Debtor with impunity, as adjudicated by an Arbitration Panel consisting of two
24 former Justices of the Nevada Supreme Court and one former United States
25 District Judge for the District of Nevada; and
- 26 • Since at least January 22, 2008, South Edge has been in default under its Credit
27 Agreement with the Lenders; not as a direct consequence of South Edge's
28 financial condition, but rather, as the direct result of its controlling insiders'

1 strategic and self-interested decision to breach their contractual commitments to
2 South Edge.

3 An operating trustee will be charged with managing South Edge in furtherance of the
4 interests of its estate and creditors. As an independent fiduciary, the trustee will be able to
5 promptly take the steps necessary to address these issues and to focus on the immediate and
6 longer term needs of the Project. Given the challenging economic environment, the focus must
7 be on constructive solutions, and collaboration with local government officials and other parties
8 in interest. A Chapter 11 trustee, in stark contrast to Debtor's conflicted management, can fulfill
9 this much needed role.

10 This bankruptcy proceeding is the last and best opportunity to salvage the Project and
11 extract value for Debtor's creditors. Appointing a Chapter 11 trustee, who will function as an
12 independent fiduciary, will ameliorate the damages created by the Builder-Defendants' ongoing
13 waste and mismanagement. There are significant value-creating LID project opportunities for
14 South Edge to pursue, but Debtor's conflicted insider management is not taking any affirmative
15 steps to realize such value. A Chapter 11 trustee will provide South Edge with the much-needed
16 independent, objective and value-driven leadership that its creditors deserve, thereby providing a
17 meaningful opportunity for the Project to survive through a plan of reorganization that either
18 provides a liquidating trust or a reorganized South Edge solution. There are at least four steps a
19 Chapter 11 trustee can immediately take:

20 1. **Enforce Takedowns.** A trustee will have standing to enforce the defaulting
21 Members' obligation to complete their "Takedowns," or to compensate South Edge for the
22 defaulting Members' failures to complete the Takedowns. Only a trustee can fill this role,
23 because the South Edge Operating Agreement, as construed by the arbitrators in the recent
24 Arbitration Award, requires the defaulting Members' consent to Debtor's collection actions
25 against them.

26 2. **Recover LID Proceeds.** A trustee can collect over \$89 million of LID proceeds
27 and protect the LID bond process from being defeased by the City of Henderson ("COH" or the
28 "City") and LID bondholders. Those parties are concerned that the Project may be abandoned by

Debtor as a consequence of the controlling Builder-Defendants' insiders' sabotage and wrongful shut down of the Project. A small amount of additional work to be arranged by a trustee can result in significant LID recoveries that can be used, in turn, to complete more LID projects and obtain additional LID proceeds, on a rolling basis. *See* Ross Decl. at ¶18 (describing scope of LID recoveries). Moreover, a Chapter 11 trustee can renegotiate and update the Project entitlements (*i.e.*, the process by which South Edge obtains approvals from the COH to develop the Project), plans, specifications and budgets with COH in order to develop a more viable and valuable Project, consistent with the post-bubble realities.

3. **Efficient Management of the Project.** A trustee can work with COH and other constructive parties (*e.g.*, Focus) to protect and salvage the Project from the continuing waste, neglect and abuse it now suffers. A trustee could preserve the value of the Project by allocating funds to address essential maintenance and cost-effective and affordable work, much of which is required to preserve COH permits and entitlements or for smart business practices. A trustee can also provide an independent assessment of the Project to the Lenders and COH and determine what changes to make in design and specifications for this Project in order to make it viable and feasible in the current economic environment.

4. **Develop Reorganization Plan.** Finally, a trustee can facilitate a timely and cost-effective exit strategy for South Edge and other parties in interest, including the Lenders. Because the Loan Documents have voting requirements different from (and more stringent than) those contained in the Bankruptcy Code, a consensual, out of court restructuring would be difficult, if not impossible, without the benefit of a Chapter 11 proceeding.

By empowering a trustee to recover for the estate from these Builder-Defendant insiders what they refuse to pay to the Debtor, the value of this Project and its LID proceeds can be salvaged before it's too late. That is important not only to the Lenders and Focus, the innocent Member, but also to the holders of \$102 million in LID bonds, the City of Henderson, Inspirada homeowners, and other parties in interest. Unlike the Builder-Defendants, the Lenders have not given up on South Edge, and hope to have the opportunity to pursue collaborative arrangements with a Chapter 11 trustee in order to preserve and create value for this estate. The Lenders

1 support this involuntary case in order to try to maintain and increase the value of the Project,
 2 Takedown claims, and the LID financing and to ameliorate the damages created by the Builder-
 3 Defendants' ongoing waste, self-dealing and mismanagement; thereby increasing the prospect of
 4 recovery for all creditors including the petitioners.

5 6 7 8 9 10 11 12 13 14 15 16 17 18 19 20 21 22 23 24 25 26 27 28

II. FACTS

A. Background and Current Situation

South Edge is a special-purpose, limited liability company-joint venture that owns
 Inspirada, a nearly 2,000-acre real estate project that was begun by some of the nation's most
 successful homebuilders shortly before the real estate bubble burst. This "new urbanism"
 development in Henderson, Nevada, is the sole business of this "single-asset real estate" debtor
 (see §101(51B) of the Bankruptcy Code). The Project was designed by eight builders, who are
 South Edge's members (collectively the "Members" and each a "Member"), as a joint venture for
 pooling their resources to build common infrastructure on a cost-effective basis with
 (1) \$585 million in Loans (defined below) from a large group of Lenders (defined below)¹ for
 whom JPMorgan acts as "Administrative Agent" and collateral agent, (2) \$102 million in public
 bonds known as "LID" bonds, and (3) Member capital contributions. The Project was designed
 to ensure timely repayment of the Loans through the Member's periodic purchase from the
 Debtor of their allocated portion of the Project's real property, a process referred to as a
 "Takedown," the precise mechanics of which are described below.

Out of eight Members, two Members currently are being liquidated by trusts created under
 confirmed Chapter 11 plans and as a consequence, have defaulted on their obligations. One
 Member (Focus South Group, LLC ("Focus")) has honored its Takedown obligations in
 accordance with the applicable agreements. The remaining five "Builder-Defendants",²

¹ At present, there are approximately 39 Lenders, some original lenders and some successors or assignees.

² Movant collectively refers to those confirmed defaulting Members and their guarantor-Parent corporations
 as the "Builder-Defendants," because they are defendants in both (i) the Completion Guaranty Actions (defined
 herein) and the UCC Actions (defined herein) commenced by JPMorgan that are referenced in Hough Decl. as
 Exhibits A and B (together, the "Nevada Actions"), and (ii) the Debtor-Members' arbitration resulting in an
 (Footnote continues on next page.)

1 representing a supermajority of equity interests of the Members, have elected wrongfully to shut
2 down the Project and hold it hostage. These insiders' ransom demands include relief of sufficient
3 liabilities in order to assure that they can acquire their allocated interests in the Project at an
4 unfairly large discount, and thereby realize huge future profits. The insiders' hostage-ransom
5 strategy purposely ignores their contractual obligations to Debtor and to the Lenders, as well as
6 their fiduciary duties to Debtor's creditors generally.

7 Since January 22, 2008, South Edge has been in default under its Credit Agreement with
8 the Lenders as a result of numerous willful breaches before and after the maturity of the Loans.
9 For example, South Edge has failed to make the requisite principal and interest repayments to the
10 Lenders because the Builder-Defendants have failed to pay their agreed Takedowns to South
11 Edge. Moreover, in the spring of 2008, certain Members of South Edge chose to cease making
12 any further capital contributions to South Edge, intentionally shutting down the Project and
13 leaving it dormant for the past two and a half years. In addition, instead of authorizing the
14 requisite funding to complete ongoing projects supported by the LID bonds, or other essential
15 work necessary to maintain improvements and equipment and avoid waste, the Builder-
16 Defendants chose to pay their respective lawyers to wage a litigation campaign in an attempt to
17 intimidate the Lenders and coerce undeserved concessions in favor of those insiders.

18 The Debtor's management committee is mired in perpetual deadlock and dysfunction,
19 refuses to undertake further development of the Project, and even fails to arrange for essential
20 health, safety and maintenance work at the Project that would, if completed, result in millions of
21 dollars of cash payments to the Debtor funded by LID bond proceeds. The wrongful actions of
22 the controlling Builder-Defendants (led by KBHN with an approximate 49% interest, plus a veto
23 on any material decision), threaten essential City permits and entitlements and Debtor's access to
24 vital LID bond proceeds.

25 (Footnote continued from previous page.)

26 arbitration award (discussed in greater detail herein and in the Hough Decl.). The Builder-Defendants include the
27 following members of South Edge: Meritage Homes of NV ("Meritage"), Coleman-Toll Limited Partnership
28 ("Toll"), Beazer Homes Holding Corp. ("Beazer"), KB Home Nevada, Inc. ("KBHN") and Pardee Homes of Nevada,
Inc. ("Pardee"), together with their respective Parent entities.

1 In May 2009, Focus³ (the only non-defaulting Member as to Takedowns) commenced an
 2 arbitration against the controlling alliance of Builder-Defendants, in which Focus sought to
 3 (i) compel those Members' specific performance of certain contractual obligations, such as to pay
 4 the Takedowns, and (ii) recover monetary damages from the controlling Members for the loss of
 5 value to South Edge resulting from the Builder-Defendants' ongoing pattern of putting their own
 6 self-interests ahead of the best interests of South Edge and its creditors. On July 6, 2010, the
 7 arbitration panel issued its arbitration award (the "Arbitration Award"), finding that the
 8 controlling Builder-Defendants wrongfully shut down the Project and wrongfully extended the
 9 maturity of the Builder-Defendants' liability to pay the Takedowns to Debtor (and Lenders as
 10 secured creditor-assignees) in violation of their contractual obligations. *See* Hough Decl. at ¶¶33,
 11 34, 37, 38. The Arbitration Award⁴ also highlights the managerial deadlock at South Edge.
 12 Pursuant to the terms of the Arbitration Award, neither Focus nor any other Member is able to act
 13 derivatively to enforce Debtor's rights and claims for recovery of Takedown or other liabilities
 14 from the Builder-Defendants. Moreover, the Builder-Defendants retain their voting rights (but
 15 only on matters not related to their own defaults) until they are formally voted out of South Edge
 16 pursuant to the terms of South Edge's operating agreement. *See* Hough Decl. at ¶40.

17 **B. "Inspirada: its history and purpose"**

18 In 2003, preliminary discussions began among some of the nation's largest homebuilders
 19 for the creation of "Inspirada" — a large-scale "new urbanism" development⁵ project in the City
 20 of Henderson, Nevada. Inspirada was to include 8,500 residences spread over nearly 2,000 acres
 21 of land in seven "Villages," and was expected to cost at least \$1.25 billion.⁶ In addition, a

22
 23 ³ There is a separate Focus entity that is the manager of South Edge – Holdings Manager, LLC. Another
 24 Focus general affiliate, called Landtek, is the construction manager of the Project. These Focus-related creditors
 have substantial claims, although the more than \$8 million management fee owing to Holdings has been delayed,
 because the Builder-Defendants wrongfully stopped the key related work just short of completion.

25 ⁴ The Arbitration Award was entered by the Nevada District Court on November 2, 2010, and on November
 26 9, 2010, the Builder-Defendants filed a notice of appeal of the Arbitration Award. Hough Decl. at ¶ 41.

27 ⁵ The urbanism concept for Inspirada is the largest ever undertaken in Las Vegas for this style of
 development.

28 ⁶ That budget has increased to more than \$1.55 billion due to cost overruns and delays.

centrally-located, 300-acre Town Center was supposed to be an urban destination for retail, residential, commercial, gaming, office, civic and municipal uses, and was to include an additional approximately 3,000 residences. The Villages and Town Center were supposed to include two middle schools, three elementary schools, a fire station, a police station, three community parks, six neighborhood parks and miles of trail systems. The Project was organized in units, the smallest of which (20-60 acres each) were called "Pods," and the Pods were designed for mandatory acquisition by individual Members of the Debtor, in what are called "Takedown" purchases for the construction of the individual Builder-Defendants' housing projects. The Pods are grouped into seven residential "Villages" of 200-250 acres each, and a "Town Center." *See* McDonagh Decl. at ¶3. Of the original 1,953 acres in the Project, Members have acquired only 773.82 acres, resulting in 1,179 acres remaining with South Edge.

In May 2004, these homebuilders, through their subsidiary members, formed South Edge, a single-purpose entity whose sole purpose was to purchase the land for the Project from the Federal Bureau of Land Management ("BLM") at a cost of \$557 million,⁷ and then to develop it with basic infrastructure in accordance with specific Takedown contracts that are a part of the Lenders' collateral. *See* McDonagh Decl. at ¶4. The Members would then acquire the land, complete the onsite and offsite work and build houses for sale. *See id.* Unfortunately, they misjudged the market and made their deals near the top of the real estate bubble. Nevertheless, this Chapter 11 case is not occurring because of a bubble, but rather on account of how the Builder-Defendants reacted to the bursting bubble and sabotaged the Project for their own benefit.

C. The Petitioning Creditors

Section 303(b)(1) of the Bankruptcy Code requires each petitioning entity to be a "holder of a claim . . . that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount." *See* 11 U.S.C. § 303(b)(1). Section 101(5)(A) of the Bankruptcy Code defines "claim" as a "right to payment," *see* 11 U.S.C. § 101(5)(A), and section 101(10)(A) of the

⁷ At the boom time, the land purchase price for Inspirada was a record purchase price for land in the Las Vegas Valley.

1 Bankruptcy Code defines “creditor” as an “. . . entity that has a claim against the debtor that arose
2 at the time of or before the order for relief concerning the debtor.” *See* 11 U.S.C. § 101(10)(A).

3 The three petitioning creditors are JPMorgan, Credit Agricole and Wells Fargo
4 (collectively, the “Petitioners”). Each of the Petitioners is a creditor of South Edge, because each
5 holds a claim against South Edge in the form of a note that was issued pursuant to the terms of the
6 Credit Agreement (each, a “Note”). Under the Credit Agreement, each Lender makes it own
7 several – not joint – loan to the Debtor, and each Note is made payable to the order of the
8 noteholder for the sum of the Borrower’s obligation to such noteholder. *See* McDonagh Decl. at
9 ¶6. Therefore, each noteholder is an individual creditor with the right to exercise its own rights,
10 subject to the Agent’s exercise of collateral remedies for the Lenders collectively.

11 Section 303(b)(1) of the Bankruptcy Code also requires that the claim not be contingent as
12 to liability or subject to a bona fide dispute. *See* 11 U.S.C. § 303(b)(1). It is undisputed that
13 South Edge is in default under the terms of the Credit Agreement, *see* Hough Decl. at ¶¶12, 13,
14 38 (describing (i) the Debtor’s affirmation of defaults under the Credit Agreement including in
15 the Forbearance Agreement, as well as (ii) the arbitration panel’s recognition of numerous
16 defaults under the terms of the Credit Agreement and related loan documents). Moreover, there is
17 no bona fide factual or legal dispute as to the validity of the debt owing to the Lenders and
18 noteholders under the Credit Agreement and the Notes. *See* McDonagh Decl. at ¶36. South Edge
19 has a definite payment obligation to both the Lenders and the noteholders to satisfy the
20 obligations provided for under the Credit Agreement and the Notes. *Id.* Accordingly, the
21 Petitioners’ claims are not contingent as to liability, and their claims are not subject to a bona fide
22 dispute.

23 Section 303(b)(1) of the Bankruptcy Code further requires that the petitioners hold
24 unsecured claims in the aggregate amount of at least \$14,425. *See* 11 U.S.C. § 303(b)(1).
25 Notwithstanding that South Edge pledged certain collateral to JPMorgan and the Lenders to
26 secure repayment of its obligations under the Notes and the Credit Agreement, the Petitioners’
27 claims are under-secured, and the aggregate, undisputed amount of these unsecured claims are not
28 less than \$14,425. *See* McDonagh Decl. at ¶17.

Finally, in addition to the numerous payment defaults under the Credit Agreement, South Edge is months behind on payments to certain of its creditors. *See* McDonagh Decl. at ¶39. Therefore, it is beyond question that South Edge is not paying its debts as they become due.

For these reasons, the involuntary petition filed on December 9, 2010 by the Petitioners is proper pursuant to section 303 of the Bankruptcy Code, and an order for relief under Chapter 11 of the Bankruptcy Code should be granted by the Court.

D. South Edge: the Operating Agreement and the Credit Agreement

South Edge is governed by the Amended and Restated Operating Agreement of South Edge, LLC, dated as of May 3, 2004 (the "Operating Agreement," a copy of which is attached to the McDonagh Decl. as Ex. D).

(i) Operating Agreement

The Operating Agreement addresses the governance of South Edge, as well as the purchase, sale and development obligations of its Members,⁸ consistent with the Credit Agreement and related Loan Documents.

South Edge consists of eight Members, and as noted in the following chart, each Member's ownership share of South Edge is based on the amount of land it is to develop in the Project. In addition, each Member has a Parent Guarantor.⁹

Member	Parent Guarantor	Acreage	Units	Percentage Interest
Focus South Group, LLC	John A. Ritter	304.52	15.59	15.59
Meritage Homes of NV	Meritage Corporation	68.96	3.53	3.53
Alameda Investments, LLC*	Woodside Group, LLC	159.0	8.14	8.14
Coleman-Toll Limited Partnership	Toll Brothers, Inc.	205.49	10.52	10.52

⁸ Although the Operating Agreement predates the Credit Agreement, it contemplates the general structure of the loan arrangement as finally agreed to in the Credit Agreement and defers in advance that the Credit Agreement shall control (Operating Agreement at § 2.3.3.) and that the Credit Agreement Events of Default create Events of Default under the Operating Agreement.

⁹ See Section II.E *infra* describing the scope of the Parents' guarantees to JPMorgan and the Lenders.

Member	Parent Guarantor	Acreage	Units	Percentage Interest
Beazer Homes Holding Corp.	Beazer Homes USA, Inc.	50.4	2.58	2.58
KB Home Nevada, Inc. ("KBHN")	KB Home	946.38	48.45	48.45
Kimball Hill Homes Nevada, Inc.*	Kimball Hill, Inc.	122.86	6.29	6.29
Pardee Homes of Nevada, Inc.	Weyerhaeuser Real Estate Company	95.71	4.9	4.9
TOTAL		1,953.32	100.0	100.0

***Note:** Both Kimball Hill and Alameda filed for bankruptcy protection, and each rejected the Operating Agreement in their respective bankruptcy proceedings. Each is now represented by a Liquidating Trustee under a confirmed plan of reorganization. They are not "Builder-Defendants" herein.

The terms and amount of South Edge's payments to the Lenders under the Credit Agreement and applicable Notes mirror the Members' obligations in the Operating Agreement and their Takedown and other obligations under their respective "Acquisition Agreements" (titled the "Purchase and Sale Agreement and Joint Escrow Instructions"), which are also assigned to the Lenders. *See* McDonagh Decl. at ¶8. Every Member has its own Acquisition Agreement with South Edge, which is an integrated part of, and incorporated by reference in, the Operating Agreement, and the terms of each Acquisition Agreement are substantially identical. *See id.*

The management of South Edge's affairs is exclusively vested in a Management Committee, which includes one representative per Member (each, a "Manager"). *See* Operating Agreement, Section 5.1.1.

One of the most significant responsibilities of the Management Committee, as provided for in the Operating Agreement, is to determine the appropriate amount of Capital Contributions to be made by the Members to South Edge to cover its' expenses. These expenses include ongoing development costs, interest payments, principal payments for the land financing, maintaining interest reserves (Operating Agreement, §2.3.3), funding Management Fees (§2.3.7), as well as ongoing payments for post-auction planning, engineering, legal and other incidental expenses (§2.3.1).

1 Except as to certain matters, the Operating Agreement provides that the Management
 2 Committee shall act by an affirmative vote of the Managers representing a majority of the
 3 membership percentage interests. *See* Operating Agreement at §5.1.1. All actions taken by South
 4 Edge must be by quorum, which includes at least three Members and a 60% majority of the
 5 membership interests. *See Id.* at §5.2.4. Therefore, as a result of KBHN's 49% share, a quorum
 6 can not be achieved without KBHN, and its proportionate share in South Edge provides it with a
 7 veto and an enormous amount of control over South Edge's actions.

8 (ii) *Credit Agreement*

9 South Edge completed the purchase from BLM, in part, with funds loaned by Lenders
 10 pursuant to a Credit Agreement dated November 1, 2004, among South Edge, as "Borrower,"
 11 JPMorgan, as "Administrative Agent" and as a "Lender," together with the other "Lenders" from
 12 time to time party thereto (the "Lenders"), which was amended by the Amended and Restated
 13 Credit Agreement, dated March 9, 2007 (the "Credit Agreement").¹⁰ *See* McDonagh Decl. at ¶5.

14 In addition to funding the purchase of the BLM land, the Credit Agreement also provided
 15 funding for the construction of the major infrastructure on the Project. *Id.* at ¶12.

16 The Operating Agreement required each Member to enter into an Acquisition Agreement
 17 with South Edge. *See* Acquisition Agreement, Recital A ("Builder is currently a Member of
 18 Developer. Pursuant to the Operating Agreement of Developer, Builder is to enter into this
 19 Agreement with respect to the 'Property' Builder shall ultimately acquire from Developer"). *See*
 20 *also* Operating Agreement §§ 2.3.4 and 6.11.3, as amended, incorporating the Acquisition
 21 Agreements. *See* McDonagh Decl. at ¶12.

22 In order to facilitate the construction of the Project, the Members agreed to purchase
 23 through their Takedowns, on a set schedule at the specified price with formula escalators to
 24 recover all of Debtor's infrastructure costs, specific parcels of the Project from South Edge. *See*

25 ¹⁰ A copy of the Credit Agreement is attached to the McDonagh Decl. as Exhibit A. The Credit Agreement
 26 has four "facilities." Facility A is a construction loan that is drawn down by South Edge as needed, Facilities B and
 27 C are term loans that were fully funded at the closing of the Credit Agreement, and Facility D provides for letters of
 28 credit available to South Edge. The original 2004 Credit Agreement is substantially the same as the Credit
 Agreement, and has been omitted for brevity.

McDonagh Decl. at ¶12. As explained in the Arbitration Award, KBHN and its allied Builder-Defendants compelled Focus to acquire all of its land with timely Takedowns just weeks before KBHN and its allies forced South Edge to wrongfully shut down the Project and refused to make their own further Takedown payments owing to South Edge. Therefore, Focus is the only non-defaulting Member under the Operating Agreement as to the Takedowns.

The schedule for the land purchases from South Edge (*i.e.*, the “Takedowns”) was specifically set up to align South Edge’s periodic needs with the maturity of the Loans provided by JPMorgan and the Lenders. The Acquisition Agreements and the Takedown schedules provided therein were essential to the Credit Agreement, because they provided the means by which the Loans would be repaid to JPMorgan and the Lenders. *See* McDonagh Decl. at ¶13. The payments from the Members to South Edge in connection with land purchases were intended to provide South Edge with funds that it would use, as Borrower, to repay its liabilities and obligations to Lenders under the Credit Agreement and other Loan Documents, as well as other creditors thereafter and by which the LID project work could be funded. *See id.* The Builder-Defendants’ past-due Takedown obligations owing to South Edge exceed \$270 million, but the Builder-Defendants’ claim they never have to repay those debts, unless and until they choose to do so, because (absent a Chapter 11 trustee) the Builder-Defendants can veto any collection action Debtor may attempt. *See* Award at 15, a copy of which is annexed as Ex. D to the Hough Decl.

E. The Lenders’ Rights

(i) Guaranties

When South Edge entered into the Credit Agreement with JPMorgan and the Lenders, each Member and its respective parent also executed the following guaranties (collectively, the “Guaranties”) in favor of JPMorgan, as Administrative Agent under the Credit Agreement: (1) a Completion Guaranty, which guaranties the completion of certain improvements on the Project and the payment of certain development costs (discussed below), (2) a Limited Guaranty (also known as a “bad boy guaranty”) under which the Member and parent guaranty payment for damages related to certain fraudulent and/or unlawful acts, and (3) a Repayment Guaranty, which

1 is triggered in the event of an involuntary or voluntary bankruptcy of South Edge. *See*
 2 McDonagh Decl. at ¶20.

3 Under each Guaranty, the Member and its Parent are jointly and severally liable for their
 4 share of the guarantied obligations.

5 (ii) *Collateral Documents*

6 The Lenders were willing to make these substantial Loans only if they were adequately
 7 secured. As security for the Loans underlying Inspirada, the Lenders required—and obtained—
 8 both liens on the land and related Collateral, including on South Edge's rights to payment vis-à-
 9 vis the Members and their Parents and LID bond proceeds. *See* McDonagh Decl. at ¶15
 10 (describing in greater detail the collateral documents pledged to JPMorgan and the scope of the
 11 security interests in various forms of collateral). South Edge, as the purchaser of the land, holds
 12 title to it (subject to JPMorgan's lien and the Deed of Trust of JPMorgan). In addition, the
 13 security agreements among the Loan Documents create security interests in all of Debtor's
 14 personal property, including the assigned Acquisition Agreements and the Operating Agreement
 15 rights to payment owing to Debtor, as well as LID proceeds and certain MI Deposits.¹¹ *Id.* The
 16 Lenders relied not only on the land, but also, among other things, on the (i) guarantors'
 17 Completion Guaranties to improve that Project, (ii) assignment of the Takedown payments and
 18 MI Deposits owing to Debtor, and (iii) the LID proceeds from the \$102 million LID bond
 19 issuance.

20 **F. Members' Failure to Pay and South Edge's Defaults**

21 The Project commenced after the Credit Agreement, Loan Documents and Collateral
 22 Documents were executed. The Lenders honored all draw requests until approximately March
 23 2008, when the Builder-Defendants wrongfully shut down the Project and repudiated their
 24 obligations to South Edge and Lenders, as described in the Arbitration Award. *See* Hough Decl.
 25 at ¶38.

26 ¹¹ An "MI Deposit," as defined in §2.3.6 of the Operating Agreement, is the sum equal to thirty percent
 27 (30%) of the projected total Member Costs (defined in the Operating Agreement) that is deposited by a Member at
 28 the closing of the conveyance of the Pods.

1 In mid-2006, less than two years after the signing of the Credit Agreement, South Edge,
2 through its Members (including KBHN), reached out to JPMorgan to seek an extension of the
3 Takedown schedule. *See* McDonagh Decl. at ¶22. Pursuant to the Loan Documents, South Edge
4 could not modify the Takedowns or schedules without JPMorgan's consent. *See Id.*

5 With some concessions from South Edge, and because certain changes beneficial to the
6 Lenders occurred (such as a higher appraisal value and higher density for the Project, which both
7 increased the value of the collateral), JPMorgan agreed to extend the Takedown schedules. The
8 Takedown schedule extensions did not change the maturity date of the Loan. At the time
9 JPMorgan consented to the extension of the Takedown schedule, South Edge and JPMorgan also
10 began to discuss amending the Credit Agreement to increase the aggregate loan amount to South
11 Edge. *See* McDonagh Decl. at ¶23. On March 9, 2007, JPMorgan and South Edge entered into
12 the Amended and Restated Credit Agreement, which included a \$50 million increase in Facility A
13 (the construction loan facility) and incorporated the modified Takedown schedule. *Id.* at ¶24.
14 Just prior to the closing of the Credit Agreement in March of 2007, South Edge paid off
15 Facility B. *Id.*

16 In early 2008, less than one year after entering into the amended Credit Agreement,
17 certain Members began experiencing financial problems. Two of the Members, Alameda
18 Investments LLC (Woodside Group Inc. was its Parent Guarantor, together "Woodside") and
19 Kimball Hill Homes Nevada (Kimball Hill Inc. was its Parent Guarantor, together "Kimball
20 Hill") defaulted on certain covenants in their corporate credit revolvers, and those defaults caused
21 a cross-default under the Credit Agreement. *See* McDonagh Decl. at ¶26.

22 Kimball Hill filed for bankruptcy protection on April 23, 2008,¹² causing another default
23 under the Credit Agreement. Woodside continued to have financial issues as well, and it was not
24 clear if it would be able to meet its obligations to South Edge and JPMorgan. An involuntary
25 petition was filed against Woodside by its lender creditors in August 2008 (that was later
26

27 ¹² *See* Case No. 08-10095 (SPS) (Jointly Administered) pending in the U.S. Bankruptcy Court, Northern
28 District of Illinois.

consensually converted to a voluntary chapter 11 case),¹³ and its wholly-owned subsidiary, Alameda Investments LLC (and Member of South Edge), sought bankruptcy protection on January 20, 2009. Both Members (and their respective parents) confirmed liquidating plans of reorganization, and Liquidating Trustees now represent the Members. *See* McDonagh Decl. at ¶27.

(i) *South Edge's Management Committee Freezes Further Development of Inspirada and Other Events of Default Caused By Builder-Defendants*

Even before the cross-defaults triggered by the bankruptcy filings, the Builder-Defendants caused significant South Edge defaults under the Credit Agreement and other Loan Documents by (A) wrongfully failing to (1) cause South Edge to make interest payments, (2) cure defaults of certain Members, and (3) make their scheduled Takedowns, and (B) voting to extend the agreed-upon Takedown schedule without obtaining JPMorgan's consent in contra distinction to the request made to JPMorgan in March of 2007. *See* McDonagh Decl. at ¶28; Hough Decl. at ¶32 (discussing Judge Pro's decision granting JPMorgan leave to amend its complaint). *See also* the Arbitration Award at pp. 57-58, generally confirming the Lenders' position on these disputes, annexed to the Hough Decl. as Ex. D.

In early March 2008, South Edge's Management Committee determined that it would not remit the February 2008 interest payment on the Credit Agreement. *See* McDonagh Decl. at ¶29. Soon thereafter, a controlling majority of the Management Committee (i) refused to issue capital calls to either maintain interest reserves, (ii) refused to pay financing interest, and (iii) voted to cease work on Inspirada. *See id.*

South Edge has not made any payments to either fund credit reserves or interest payments in more than two (2) years, and no further development of the Project (beyond the initial Takedown parcels) has materialized. According to a recent SEC filing by one of the Parent Guarantors, "certain of the joint venture Members have curtailed the funding of their allocable joint venture obligations." *See* Form 10-Q, pp. 12-13, Beazer Homes USA, Inc. (August 5, 2010),

¹³ *See* Case No. 08-20682 (PC) (Jointly Administered) pending in the U.S. Bankruptcy Court, Central District of California.

1 a copy of which is attached hereto as **Exhibit A**. The Arbitration Award determined that the
 2 Builder-Defendants' refusal to fund interest payments, failure to complete Takedowns, and
 3 decision to cease work on the Project constituted breaches of their obligations to South Edge.

4 (ii) *Members' Unilateral Extension of Takedown Schedule*

5 On March 9, 2007, with the Lenders' express consent, each Member signed a Second
 6 Amendment to Purchase and Sale Agreement and Joint Escrow Instructions, which extended the
 7 Takedown schedules. The amended Takedown schedule provided for the following:

- 8 i. 295.59 acres to be taken down on April 15, 2007;
- 9 ii. 483.35 acres to be taken down on October 15, 2007;
- 10 iii. 324.07 acres to be taken down on April 15, 2008;
- 11 iv. 50.4 acres to be taken down on July 15, 2008;
- 12 v. 232.51 acres to be taken down on October 15, 2008;
- 13 vi. 445.52 acres to be taken down on April 15, 2009; and
- 14 vii. 121.88 acres to be taken down on October 15, 2009.

15 *See McDonagh Decl. at ¶25.*

16 The Members completed their respective Takedowns scheduled for April 15, 2007 and
 17 October 15, 2007; however, there was a significant Takedown scheduled for April 15, 2008, and
 18 in advance of that date, some of the Members indicated that they were unsure if they would
 19 perform their respective obligated Takedowns. *See McDonagh Decl. at ¶30.*

20 With these Takedowns looming and uncertainty about whether they would be completed,
 21 JPMorgan, South Edge, the Members, and their Parent Guarantors, began discussions regarding
 22 curing the existing and pending defaults under the Credit Agreement and restructuring the terms
 23 of the Credit Agreement. *See McDonagh Decl. at ¶31.*

24 However, unbeknownst to the Agent, the South Edge Members orchestrated secret votes
 25 of the South Edge Management Committee wrongfully to extend the Takedown schedules,
 26 including those scheduled for April 15, 2008, so that their obligations to South Edge purportedly
 27 would not come due at the time agreed upon by JPMorgan in the Loan Documents. Specifically,
 28 on April 10, 2008, the Members (except for Meritage and Focus) voted to extend their Takedown

1 schedules without the Agent's knowledge or consent, even though they were aware that such
2 consent was required. *See* McDonagh Decl. at ¶32. Ordinarily, for such modifications, both
3 South Edge and the Members in their own capacity (in addition and separate from their capacity
4 as Members) had to formally and in writing extend their Takedown schedules. The Arbitration
5 Award confirms this as a breach of the Acquisition Agreements by the Builder-Defendants. *See*
6 Hough Decl. at ¶38.

7 **G. Forbearance Agreement**

8 On May 27, 2008, JPMorgan, South Edge, and the Members and the Parent Guarantors,
9 entered into a Forbearance Agreement in order to "provide [South Edge] with sufficient time to
10 propose, negotiate and close a potential restructuring of Loans advanced under the Credit
11 Agreement." The Forbearance Agreement reaffirmed all obligations owing to the Lenders and all
12 rights and liens of the Lenders. The Debtor and other Credit Parties (including the Builder-
13 Defendants) provided comprehensive releases to JPMorgan and the Lenders as well as various
14 other benefits. *See* Hough Decl. at ¶¶10-13.

15 Neither South Edge, nor any of the Members or Parent Guarantors, informed JPMorgan of
16 the secretly extended Takedown schedules at the time the Forbearance Agreement was signed. In
17 fact, South Edge specifically warranted that only limited and enumerated defaults had occurred,
18 and the Members, including KBHN, ratified such misstatements and omissions by failing to
19 apprise JPMorgan of their falsity. *See* Hough Decl. at ¶14.

20 Following the signing of the Forbearance Agreement, JPMorgan, South Edge, the
21 Members, and the Parents sought to restructure the Loans under the Credit Agreement, but those
22 efforts were unsuccessful, and the Forbearance Agreement terminated, by its own terms, on June
23 30, 2008. After South Edge, the Members, and the Parent Guarantors refused to cure the
24 numerous defaults, make the balancing payments, or assure any performance under the Credit
25 Agreement, Loan Documents, or Collateral Documents, JPMorgan commenced two sets of
26 actions (i.e., the Nevada Actions) against each of the Builder-Defendant Members and Parent
27 Guarantors.
28

1 More recently, Lenders have sent South Edge an updated notice of defaults, dated
 2 November 23, 2010, as well as a related demand for information and documents, as provided for
 3 under the Credit Agreement. *See* McDonagh Decl. at Ex. J and Ex. K. These chronic problems
 4 illustrate why a Chapter 11 trustee is essential to speak and act for South Edge, because otherwise
 5 no credible party has the right and power to do so.

6 **H. Commencement of Litigation and Arbitration**

7 (i) *Litigation Commenced by Lenders*

8 The first set of actions, filed in the Southern District of New York on December 5, 2008,
 9 against the Builder-Defendant Members of South Edge and Parent Guarantors, were based on the
 10 Completion Guaranties executed by each of the defendants (the "Completion Guaranty Actions").

11 On that same day, JPMorgan also filed a second set of actions against the Builder-
 12 Defendant Members of South Edge and their Parent Guarantors (the "UCC Actions") in the
 13 District of Nevada. The UCC Actions seek to enforce the collateral pledged to JPMorgan
 14 pursuant to the Credit Agreement and Loan Documents, including the Takedowns owing in
 15 excess of \$270 million, and also seek damages for certain torts committed by KBHN, KB Home
 16 and other Builder-Defendants.¹⁴

17 The litigation is not likely to result in tangible benefit for the Lenders or South Edge
 18 within the time frame necessary to save the expiring entitlements, access the LID bond proceeds
 19 and preserve important Project value.

20 (ii) *Focus' Arbitration Proceeding*

21 In May of 2009, Focus, as a Member of South Edge, filed a demand for arbitration against
 22 the other Members of South Edge, including KBHN, on behalf of itself *and South Edge*, and it
 23 sought relief in the arbitration both for itself and for South Edge. Focus was the only Member of
 24

25
 26 ¹⁴ On May 26, 2009, an order was entered, pursuant to the motion of KBHN, KB Home, and the other
 27 Builder-Defendant Members and Parent Guarantors, transferring the Completion Guaranty Actions to the District of
 28 Nevada where the UCC Actions were pending. The Completion Guaranty Actions were eventually consolidated with
 the UCC Actions in front of the Honorable Philip M. Pro in case number 2:08-cv-01711.

1 South Edge that (i) did not default on its Takedown obligations under the Operating Agreement
2 and (ii) performed all of its Takedowns under its Acquisition Agreement.

3 Focus sought, among other things, to require KBHN and the other Members to honor and
4 specifically perform their contractual obligations to South Edge, including satisfying the
5 Takedowns past due and owing to South Edge. By operation of the Credit Agreement and other
6 Loan Documents, any such recovery by South Edge would result in substantial payments to
7 JPMorgan to pay down the Loan and salvage the collateral.

8 The Arbitration proceeding was involved and comprehensive. The arbitral panel was
9 made up of two retired Chief Justices of the Nevada Supreme Court and a retired United States
10 District Judge for the District of Nevada. The Arbitration hearing was conducted over a two
11 week period, beginning on February 22, 2010. In the course of the Arbitration, more than 1,300
12 exhibits were submitted to the Arbitration panel and at least thirteen witnesses testified. The
13 Arbitration's closing arguments were heard on March 11, 2010.

14 In the Arbitration Award, the arbitration panel determined that the defaulting Builder-
15 Defendants breached their agreements by (i) failing to fund interest payments, (ii) voting to cease
16 construction on the Project, (iii) refusing to make their Takedowns, and (iv) purporting to extend
17 the Takedown schedule. In the end, the only cash award was to Focus to compensate for the
18 Builder Defendants' direct and immediate breach of contract, in the sum of \$36,815,354. The
19 Panel determined this amount was equivalent to the diminution in value of Focus' investment in
20 the Project resulting from the breaches by the other Builder Members. *See Hough Decl.* at ¶¶38-
21 39.

22 However, the panel's decision fosters managerial deadlock and does not rectify South
23 Edge's governance, because, under the panel's interpretation of the Operating Agreement, no
24 Member is able to compel KBHN and the other defaulting Members to perform their past-due
25 Takedowns to South Edge—*i.e.*, pay down a significant portion of the money owed to JPMorgan
26 and the Lenders under the Credit Agreement. The panel concluded that Focus could only
27 commence arbitration on its own behalf and could not assert claims on behalf of South Edge,
28 because Focus, as the only non-defaulting Member, is not permitted to singularly form a quorum

1 under the Operating Agreement. Rather, the panel found that the Management Committee, duly
 2 constituted, is the only entity with the authority to bring an arbitration on behalf of South Edge.
 3 In this regard, the panel concluded that the Members retain their right to vote until they are
 4 formally voted out under the Operating Agreement. *See* Hough Decl. at ¶40. •

5 Despite its multiple findings of wrongdoing on the part of the Builder-Defendants, the
 6 Arbitration Award created a quagmire allowing KBHN and the other Builder-Defendants to
 7 continue to stall payment to the Debtor on their respective Takedowns, because there can never
 8 be a quorum of the Management Committee sufficient to authorize enforcement actions against
 9 them absent KBHN's consent. Moreover, there is no recourse if Builder-Defendants choose to
 10 not capitalize any of the necessary infrastructure projects required by the City, because the
 11 arbitration panel concluded that the Members retain their right to vote on matters unrelated to
 12 their defaults until they are formally voted out under the Operating Agreement. *See* Hough Decl.
 13 at ¶40.

14 By supplanting Debtor's managers and maintaining sole control over Debtor's affairs, a
 15 Chapter 11 trustee could quickly enforce the obligations owed by Builder-Defendants, relying in
 16 part on the doctrine of collateral estoppel to show the Builder-Defendants are in default. Absent
 17 this Court approving the appointment of a Chapter 11 trustee who can step in and make rational
 18 and objective fiduciary decisions for South Edge, the breaching Builder-Defendants will continue
 19 to hold the Debtor and Project hostage with their confirmed wrongs against South Edge until such
 20 day -- likely to be more than 18 months to two years from now -- when JPMorgan obtains a final
 21 judgment in the Nevada Actions. Until then, South Edge and the Project will continue to suffer
 22 irreversible damage as a result of the Builder-Defendants' abusive hostage strategy, including
 23 access to significant LID bond proceeds.

24 **I. South Edge's Current Management Is Hopelessly Conflicted and Is De-**
 25 **Valuing the Project**

26 The Builder-Defendants, who compromise a majority of the Management Committee, are
 27 all a party to the Nevada Actions in which JPMorgan is seeking to enforce the guarantees
 28 provided by the Builder-Defendants and their parent guarantors in connection with the Credit

1 Agreement. The Builder-Defendants have chosen to abandon their managerial duties, because
2 their primary motivation is to minimize their individual exposures in the Nevada Actions and
3 ultimately settle for less than what is being sought by JPMorgan, thereby acquiring the Project
4 "on the cheap."

5 [REDACTED]
6 [REDACTED]
7 [REDACTED]
8 [REDACTED]
9 [REDACTED]
10 [REDACTED]
11 [REDACTED]
12 See Ross Decl. at ¶19.
13 [REDACTED]
14 [REDACTED]
15 [REDACTED]

16 One way to advance the Builder-Defendants' hostage strategy is for the Builder-
17 Defendants to de-value the Project, which serves as JPMorgan's collateral, and inhibit the
18 development and maintenance of the Project. As majority Members of the Management
19 Committee, the Builder-Defendants have utilized their power to do exactly that. Over the
20 approximate past two and a half years, the Builder-Defendants have intentionally made the
21 Project less valuable by (i) refusing to make their respective Takedowns and (ii) failing to fund
22 critical infrastructure projects, while blocking LID recoveries and refusing the City's willingness
23 to improve and preserve the expiring or threatened entitlements and permits.

24 KBHN and Toll are a part of a larger venture that is bound by a set of rules, as set forth in
25 the Credit Agreement and related Loan Documents, including the Operating Agreement. These
26 parties have chosen to disregard those rules and only concern themselves with their bottom lines.
27 In fact, KBHN and Toll are stalling all work on the Project in order to give their competing units
28

1 an unfair advantage. Their self-interested actions have severe negative repercussions for the
2 entire joint venture.

3 The Project and LID recoveries must be managed in a more effective manner, and an
4 independent third party who does not have an equity interest in the Project would be better suited
5 to undertake and execute such responsibilities and collect the Takedowns.

6 (i) *The Majority of the Members of the Management Committee Have*
7 *Breached Their Contractual Obligations and Frozen Development at*
8 *Inspirada*

9 The Builder-Defendants can not be trusted to equitably regulate and manage South Edge
10 and ensure that their actions do not harm Debtor's interests and those of its creditors.

11 The Builder-Defendants have wielded control over the Project to the detriment of third
12 parties by failing to fulfill their obligation to make the Takedowns required by the Operating
13 Agreement and related Acquisition Agreements. By making a Takedown, the builder pays South
14 Edge for the land (against which JPMorgan holds a lien), and in exchange, the builder obtains
15 title to the land. South Edge can then use those Takedown proceeds to repay the sums due and
16 owing to JPMorgan or with the Lenders' consent, use those funds for other beneficial tasks on the
17 Project. Once it obtains title to the land, the builder can then develop the land, ideally in an
18 improved and higher-value plan in collaboration with COH. Beginning in 2008 and continuing
19 ever since then, the Builder-Defendants chose to not make the requisite Takedowns. As was
20 recently confirmed by the Arbitration Award, there is no legal justification for the Builder-
21 Defendants' failure to fulfill their Takedown obligations to South Edge.

22 At the time of the March 2008 default when the Management Committee voted to cease
23 any further development efforts at Inspirada, Focus was the only Member to (i) have completed
24 all of its Takedown obligations and (ii) fully advanced its MI deposits and its portion of the
25 financing interest required under the Credit Agreement. Almost all of Focus's land was located
26 in "Town Center," a mixed residential-commercial part of Inspirada, as opposed to other purely
27 residential villages. The fundamental problem for Focus was that before the Town Center could
28 be developed, major infrastructure improvements had to be installed, but the [REDACTED]
[REDACTED]

[REDACTED] See Ross Decl. at ¶20. In fact, COH may declare Inspirada to be “abandoned,” which would result in loss of a valuable source of financing for South Edge. See Ross Decl. at ¶17.

The Management Committee has wrongfully quashed further development efforts. [REDACTED]

[REDACTED] See Ross Decl. at ¶21. This effectively blocked additional competition for KBHN and Toll from the other Members, who would otherwise be competing to sell homes to consumers interested in purchasing a home in Inspirada.

(ii) *South Edge Is Not Maximizing Potential Recoveries on LID Bonds*

Construction on the LID improvements at Inspirada commenced in the summer of 2006. One hundred fifty four (154) projects are contemplated, some of which have been substantially completed or advanced with Loan funds before the Project shutdown. See Ross Decl. at ¶6. To date, three (3) projects have been completed and turned over to COH, and South Edge received approximately \$1.3 million of reimbursements in November 2007 and January 2008 from COH. See *Id.* at ¶7. The Builder-Defendants have inexplicably chosen to cease funding significant work on the Project that would provide South Edge with tens of millions of dollars in LID recoveries.

[REDACTED] See *Id.* at ¶13.

Moreover, to the extent that South Edge has completed specific improvements within Inspirada, it is failing to diligently recover reimbursements that COH is holding to distribute to South Edge. See Ross Decl. at ¶10. For example, approximately \$1.035 million of LID bond proceeds is pending distribution for completed work that was initiated well over two years ago. The final step necessary to obtain the release of those funds is for South Edge to deliver a formal letter to COH requesting that COH accept the underlying improvements. This letter could have

1 been sent in May 2010. However, Holdings Manager, LLC still has not signed this document,
2 and South Edge still has not received the approximate \$1.035 million of LID funds. *See Id.*

3 There can be no justification why South Edge's insider defendant management would
4 want to wait more than two years to recover funds rightfully due and owing to it, unless South
5 Edge's management's hostage goal is to starve South Edge of resources, and make the Project
6 and its Lenders suffer. An independent and objective fiduciary is needed to ensure that South
7 Edge timely completes its improvement projects and once completed, immediately recovers all
8 sums it is rightfully owed.

9 **J. South Edge Has Valuable Assets That Must Be Preserved**

10 If development of the Project is allowed to proceed and LID recoveries or other funds are
11 timely allocated to address certain pressing needs, as discussed in greater detail below, value can
12 be created that will benefit South Edge and all of its creditors. A Chapter 11 trustee could
13 immediately start working with the City to adjust and improve the Project entitlements and Plans
14 and Specifications to the post-bubble economic realities, creating significant value that the
15 Builder-Defendants wish to stall until it is believed after they can buy the Project at distressed
16 prices.

17 (i) *The Plans and Specifications for Inspirada Must Be Updated*

18 According to the offering statement for the LID Bonds (the "Offering Statement"), in
19 April 2006, it was anticipated that the Takedowns would be completed by April 15, 2009. In
20 addition, it was anticipated that Inspirada's infrastructure would be fully constructed by the end of
21 calendar year 2009. The Offering Statement also provided for estimated buildout dates by the
22 Members of their respective parcels. In April 2006, it was contemplated that the buildouts of
23 residential product by Alameda, Kimball Hill Homes Nevada, Pardee, Meritage and Beazer in the
24 seven Villages would be completed by Spring 2012. *See Ross Decl. at ¶28.*

25 Only Villages 1 and 2 have been constructed, and the development of Village 3 has
26 stalled. *See Ross Decl. at ¶29.*
27
28

(ii) *Local Improvement District (“LID”) Funds*

In April 2006, the City of Henderson raised more than \$100 million by issuing T-18 Local Improvement District (Inspirada) Limited bonds (“LID Bonds”)¹⁵ to buy certain roads and other potential public infrastructure after it was built by South Edge. *See* Ross Decl. at ¶5. However, the Builder-Defendants wrongfully shut down the Project and blocked these recoveries, including work desired by COH that was nearly completed. A Chapter 11 trustee working with JPMorgan could complete some of that remaining work and recover significant funds for the estate.

To date, South Edge has spent approximately \$43,343,618 on LID improvements. Should South Edge be able to complete these improvements and satisfy other requirements, it will be entitled eventually to recover at a minimum \$91,956,686 (less a 2.5% fee payable to the COH Engineer and the cost of the work and financing). *See* Ross Decl. at ¶8.

South Edge needs that attractive financing, and the Lenders would like those recoveries, even if some of them are reinvested in the Project collateral. This is a “win/win” for everyone except, apparently, the Builder-Defendants who are trying to stall the development and claim these value enhancement opportunities later for themselves. A Chapter 11 trustee can prevent this inexcusable waste and self-dealing that Builder-Defendants are imposing upon South Edge and its creditors.

(iii) *Causes of Action*

The Chapter 11 trustee can be exceptionally cost efficient in recovering the claims of Debtor against the Builder-Defendants. For example, the doctrine of collateral estoppel should permit the trustee to enforce the Takedown obligations owed by those Builder-Defendants, because the arbitration panel already decided that the Builder-Defendants are in breach of those obligations. The Arbitration Award also contains other findings that support claims the trustee may consider bringing against the Builder-Defendants, such as claims for breach of fiduciary duty, fraudulent transfers and equitable subordination of any sums allegedly due from South Edge to the Builder-Defendants.

¹⁵ The LID Bonds are paid like property taxes on the applicable land.

III. LEGAL ARGUMENT

A. A Trustee Must Be Appointed During The “Gap Period” Of This Involuntary Chapter 11 Case

Section 1104(a) of the Bankruptcy Code authorizes the Court to appoint a trustee in Chapter 11 cases for “cause” at “any time after the commencement of the case but before confirmation of a plan....” 11 U.S.C. § 1104(a). Under the statute, “cause” specifically includes “fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management....” 11 U.S.C. § 1104(a)(1).

In the context of involuntary Chapter 11 bankruptcy cases, a trustee may be appointed for cause at any time after the filing of the involuntary petition—including during the “gap period” between the filing of the involuntary petition and the court’s entry of an order for relief. The filing of the involuntary petition commences the case and therefore triggers the application of Section 1104. *See In re Prof'l Accountants Referral Servs., Inc.*, 142 B.R. 424 (Bankr. D. Colo. 1992) (recognizing statutory authority to appoint a Chapter 11 trustee during the gap period pursuant to 11 U.S.C. § 1104); *see also Collier on Bankruptcy* ¶303.29 (15th ed. 2010) (same). Section 105 of the Bankruptcy Code provides additional support for appointing a Chapter 11 trustee during the gap period. *Prof'l Accountants Referral Servs., Inc.*, 142 B.R. at 430 (asserting that “if necessary, the exercise of [the Bankruptcy Court’s] equitable powers under 11 U.S.C. § 105 allows for the appointment of a trustee during the gap period.”).

Courts have appointed Chapter 11 trustees during the gap period in order to prevent or stop gross mismanagement or suspected fraudulent activity. For example, in *In re Prof'l Accountants Referral Servs., Inc.*, the Court appointed a trustee to prevent further harm to the debtor’s estate and its creditors where the debtor’s current management seemed to be working at odds with the success of the corporate entity. That is, the court found that, “as opposed to fulfilling his fiduciary duties, [the company’s chief officer] had been engaged in a substantially similar and competing business...” *Id.* at 429. The Honorable Gregg W. Zive of this district granted a motion to appoint a Chapter 11 trustee in an involuntary case during the gap period where the petitioning creditors asserted gross mismanagement and fraud on the part of the

company's CEO. *In re E-Z Pay Servcs., Inc.*, Case No. BK-S-06-50567 (Bankr. D. Nev. Aug. 23, 2006). *See Exhibit B.* In that case, despite significant unresolved legal issues (including the question of whether venue was proper in Nevada), within days of the filing of the involuntary petition, the court heard the motion to appoint a "gap period" trustee on shortened notice, and ruled that "the Office of the United States Trustee should appoint a Chapter 11 trustee as soon as possible." *Id.* As discussed throughout this Motion, similar circumstances exist in this case, and it is imperative that a Chapter 11 trustee be appointed in order to stem the current gross mismanagement, preserve South Edge's assets and protect its creditors from further harm.

B. It Is Necessary and Appropriate To Appoint a Permanent Chapter 11 Trustee

Section 1104(a) of the Bankruptcy Code provides, in part, that the Court shall appoint a Chapter 11 trustee if one of the following standards is satisfied: (1) appointment "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case . . ."; or (2) appointment because it is "in the interest of creditors, any equity security holders, and other interests of the estate . . ." 11 U.S.C. § 1104(a).

A Chapter 11 debtor and its managers owe fiduciary duties to the debtor's estate and its creditors. *Hirsch v. Pa. Textile Corp. (In re Centennial Textiles, Inc.)*, 227 B.R. 606, 612 (S.D.N.Y. 1998). "As fiduciaries, the debtor in possession and its managers are obligated to treat all parties to the case fairly, maximize the value of the estate, and protect and conserve the debtor's property." (internal citations omitted) *In re Nat'l R.V. Holdings, Inc.*, 390 B.R. 690 (Bankr. C.D. Cal. 2008), quoting *Centennial Textiles*, 227 B.R. at 612. "In the appropriate case, the appointment of a trustee is a power which is crucial for the Court to exercise in order to preserve the integrity of the bankruptcy process and to insure that the interest of creditors are served." *In re Intercat, Inc.*, 247 B.R. 911, 920 (Bankr. S.D. Ga. 2000). Where there is doubt about management's ability to carry out its fiduciary duties, appointment of a trustee is the appropriate remedy. *See, e.g., Variable-Parameter Fixture Dev. Corp. v. Comerica Bank-Cal. (In re Morpheus Lights, Inc.)*, 228 B.R. 449, 454 (Bankr. N.D. Cal. 1998) (citations omitted).

1 The Builder-Defendants, as controlling Members of Debtor's management committee,
 2 have a duty to protect the best interests of Debtor's creditors by maximizing the value of the
 3 Project. They have patently and deliberately failed to do so. Over the past two and a half years,
 4 the Builder-Defendants have chosen to pursue a path that serves only their interests and severely
 5 damages the development of the Project while diminishing Debtor's value. This inherent conflict
 6 provides overwhelming "cause" to appoint a Chapter 11 trustee to collect needed recoveries from
 7 the Builder-Defendants, to restore order to Debtor's affairs and to get the Project back on track. It
 8 is clearly in the creditors' best interests to have an independent fiduciary carry out management of
 9 South Edge's affairs.

10 (i) *The Facts Before The Court Provide Overwhelming Support For The*
 11 *Appointment of a Chapter 11 Trustee.*

12 A determination of "cause" under section 1104(a)(1) of the Bankruptcy Code "is within
 13 the discretion of the court [based on] various interests involved in the bankruptcy proceeding." *In*
 14 *re Bellevue Place Assocs.*, 171 B.R. 615, 623 (Bankr. N.D. Ill.), *aff'd*, *Bellevue Place Assocs. v.*
 15 *Caisse Centrale Des Banques Populaires*, No. 94-C-5089, 1004 U.S. Dist. LEXIS 17409 (N.D.
 16 Ill. December 6, 1994); *see also Comm. of Dalkon Shield Claimants v. A.H. Robins Co. Inc.*, 828
 17 F.2d 239, 242 (4th Cir. 1987). For example, the Court may consider pre-petition activity as part
 18 of its section 1104 determination. *See Okla. Refining Co. v. Blaik (In re Okla. Refining Co.)*, 838
 19 F.2d 1133, 1136 (10th Cir. 1988); *see also In re Rivermeadows Assocs. Ltd.*, 185 B.R. 615, 619
 20 (Bankr. D. Wyo. 1995) ("the [Bankruptcy] Code is clear that the prepetition conduct of the
 21 debtor's management may be the sole deciding factor").

22 Courts also consider the existence of other factors, including, but not limited to:
 23 (a) conflicts of interest, including inappropriate relations between corporate parents and
 24 subsidiaries; (b) misuse of assets and funds; (c) inaccurate and inadequate record keeping and
 25 reporting; (d) non-filing of required documents, including lack of adequate disclosure; (e) various
 26 instances of conduct found to establish fraud or dishonesty; (f) failure to make required payments;
 27 (g) lack of credibility and creditor confidence; and (h) extreme acrimony and deep-seated
 28 animosity among the debtors and their creditors. *In re Clinton Centrifuge, Inc.*, 85 B.R. 980, 985

(Bankr. E.D. Pa. 1988), citing 5 Bankr. Service, L. Ed. § 41.30 at 49-50 (1987); *see, e.g., Lowenschuss v. Selnick (In re Lowenschuss)*, 171 F.3d 673, 685 (9th Cir. 1999) (debtor's prepetition transfer of assets from his pension plan out of Pennsylvania in order to avoid the jurisdiction of the Pennsylvania courts was "cause" for appointing a Chapter 11 trustee); *In re McCall*, 34 B.R. 68, 69 (Bankr. E.D. Pa. 1983) (granting request for Chapter 11 trustee because of debtor's incompetence and gross mismanagement of its affairs, coupled with the ongoing failure to pay monthly mortgage that diminished the sole valuable estate asset).

Once "cause" is found by a court, the appointment of a trustee under section 1104(a)(1) of the Bankruptcy Code is mandatory. *See Rivermeadows Assocs.*, 185 B.R. at 617.

Here the scores of conflicts, mismanagement and incompetence of Debtor's current self-dealing managers could not be more striking. *See* Sections 2.F, 2.H(ii) and 2.I *supra*. Value will not be maximized if such self-dealing behavior by controlling insiders is allowed to continue. A disinterested party must be put in place to ensure that the value of the *entire* Project is being maximized. By turning over decision-making authority to a Chapter 11 trustee, further construction delays could be averted, LID collections could occur more quickly, and the Project could be salvaged for the benefit of Debtor's creditors, thus restoring justice to the case.

(ii) *Even if the Court Determines That "Cause" Does Not Exist, Appointing a Chapter 11 Trustee is in the Best Interests of South Edge's Creditors Under Section 1104(a)(2) of the Bankruptcy Code*

Section 1104(a)(2) provides a "flexible standard for appointment of a trustee even when no cause exists." *See Bellevue Place Assocs.*, 171 B.R. at 623; *see also In re V. Savino Oil & Heating Co.*, 99 B.R. 518, 527 n.11 (Bankr. E.D.N.Y. 1988) ("factors constituting a basis for appointing a trustee under § 1104(a)(2) are amorphous, diverse, and necessarily involve a great deal of judicial discretion."). The standard affords the Bankruptcy Court "particularly wide discretion" to look to the practical realities and necessities involved in appointing a trustee. *See Bellevue Place Assocs.*, 171 B.R. at 623. Factors often used to determine whether appointment of a Chapter 11 trustee is in the creditors' best interests include: (1) the debtor's trustworthiness; (2) the debtor's past and present performance and prospects for the debtor's rehabilitation; (3) the confidence, or lack thereof, of the business community and creditors in present management; and

(4) the benefits derived by the trustee's appointment, balanced against the cost of appointment. See *In re Ionosphere Clubs, Inc.*, 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990); *In re Madison Mgmt. Group, Inc.*, 137 B.R. 275, 282 (Bankr. N.D. Ill. 1992). For example, in *Petralex*, a trustee was appointed under section 1104(a)(2), because the court found that the debtor could not continue its operations. The debtor's inability to operate was a result of the board being deadlocked, being unable to resolve financing problems, and not being able to operate profitably. See *In re Petralex Stainless, Ltd.*, 78 B.R. 738, 744 (Bankr. E.D. Pa. 1987). As the *Petralex* court aptly noted, "[u]nder such chaotic circumstances, a disinterested trustee can impartially assess [Debtor's] conditions and work with the warring factions, thus facilitating the decision making process." *Id.* at 745.

As confirmed in the Arbitration Award, for well over the past two years, South Edge's Management Committee has demonstrated that it is fraught with conflicts, because the majority of its Members regularly put their own economic interests ahead of the best interests of the Project. In addition to failing to make the Takedowns required by the Loan Documents, the Management Committee continues to obstruct any effort to move forward with the development of the Project, and it squanders those few opportunities it has to bring funds into South Edge on account of the limited public improvement work that has been accomplished to date.

Both Focus and the Lenders have pursued alternate courses of action (either through the Nevada Actions or the Arbitration) in an effort to wrest control of South Edge away from the Builder-Defendants and hold them responsible for their selfish and disruptive actions to the Project. Those courses of action have not provided Focus or the Lenders with the desired results. Efforts by the Lenders and Focus to advance the completion of the Project through negotiations with the defaulting Members did not provide even a modicum of success. The parties have also tried to pursue substantive settlement discussions, but those have not produced a mutually acceptable agreement. In short, over the last two and one-half years, the Builder-Defendants have had more than an adequate opportunity to engage with the Lenders, but they have chosen not to do so. Accordingly, this involuntary Chapter 11 proceeding is the best and last way to preserve

1 Inspirada and minimize any further degradation of the Project and risk of loss on the LID bond
2 proceeds and City entitlements.

3 The dismal waste and lack of progress at Inspirada is not lost on outsiders, including both
4 COH and the holders of the LID Bonds, both of which are losing patience with the stagnation at
5 Inspirada, and action must be taken to foster development before it is too late.

6 Inspirada will enormously benefit from the appointment of a Chapter 11 trustee, because
7 an independent third party who is not a party to the Nevada Actions can make objective and
8 rational business decisions that are not influenced by a desire to minimize their contractual
9 obligations or hold the Project hostage for their own gain. A Chapter 11 trustee will have control
10 over management of the Project and allocation of funds, as well as the power to enforce the
11 Takedowns and other obligations. Moreover, a Chapter 11 trustee with homebuilding and
12 development experience will restore confidence in the Project, because that individual will be
13 able to deal effectively with COH, the LID bondholders, the Lenders and other creditors, as well
14 as the honest Member, Focus. Finally, a Chapter 11 trustee will be able to forge ahead with the
15 Lenders to develop and confirm a plan of reorganization or liquidation that will maximize the
16 value of the Inspirada estate, to the benefit of its creditors and to the community-at-large.

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